OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
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SUBJECT:

This Field Service Advice responds to your memorandum dated March 9, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=
Subsidiary	=
Affiliate	=
A	=
B	=
C	=
D	=
E	=
F	=
Unrelated Party	=
F	=
G	=
Year 1	=
X	=

ISSUE(S):

Whether, in the exchange of multiple assets between Taxpayer and Unrelated Party, it was proper to classify certain assets in a single exchange group for purposes of computing the gain or loss to be deferred under I.R.C. § 1031.

CONCLUSION:

It does not appear that all of the exchanged assets in dispute should have been classified in one exchange group. The assets should be grouped in different product classes in accordance with Treas. Reg. § 1.1031(a)-2(b)(3).

FACTS:

We primarily rely on the facts set out in your memorandum dated March 5, 1999. In addition, we rely on facts obtained from discussions with your office, and from the Revenue Agent's workpapers and other documents we were provided.

A was formed in 1983 as a wholly-owned subsidiary of Taxpayer. In Year 1, the year in dispute, A was renamed Subsidiary. Affiliate is also indirectly owned by Taxpayer.

At the time of the exchange, E and F were wholly-owned subsidiaries of Subsidiary. In addition, Subsidiary owned and operated B, C and D. B was a operation; C and D operated . The parties to the exchange in dispute were Unrelated Party, on one side, and Subsidiary and Affiliate for Taxpayer, on the other.

In January of Year 1, Subsidiary and Affiliate entered into an asset exchange agreement with Unrelated Party. Under the agreement, Unrelated Party exchanged assets for assets. The exchanged assets included real property, such as and , and machinery and equipment. The exchange was completed on June 25 of Year 1.

For tax purposes, Subsidiary accounted for the exchange as a multiple-properties exchange under Treas. Reg. § 1.1031(j). The exchanged properties that could be classified into exchange groups in accordance with General Asset Classes were so classified. The remaining properties, consisting of machinery and equipment, were placed in a distinct group, identified as equipment.

Examination agrees that Treas. Reg. § 1.1031(j) covers the instant asset exchange. However, Examination disputes the classification of the remaining properties into a single exchange group. Accordingly, the Revenue Agent has proposed separating the machinery and equipment into three separate groups based on product classes

set forth in the Standard Industrial Classification Manual. Grouping the assets in this manner results in the recognition of additional gain in the amount of X.

LAW AND ANALYSIS

Section 1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held for productive use in a trade or business or for investment.

Treas. Reg. § 1.1031(a)-1(b) defines the words "like kind" as having reference to the nature or character of the property and not to its grade or quality. Further, the regulation provides that one kind or class of property may not, under the nonrecognition provisions of section 1031(a), be exchanged for property of a different kind or class.

Treas. Reg. § 1.1031(a)-2(a) provides that personal property of a like class is considered to be of a like kind for purposes of section 1031. In addition, an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class.

Treas. Reg. § 1.1031(a)-2(b)(1) provides that depreciable tangible personal property is exchanged for property of a like kind within the meaning of section 1031 if the property is exchanged for property that is either of a like kind or a like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property's class is determined as of the date of the exchange.

Treas. Reg. § 1.1031(a)-2(b)(3) provides that, except as modified, property within a Product Class consists of depreciable tangible personal property that is listed in a 4-digit product class within Division D of the Standard Industrial Classification codes set out in the Standard Industrial Classification Manual, (the SIC Manual), produced by the Office of Management and Budget. The regulation further provides that if a property is listed in more than one product class, the property is treated as listed in any one of those product classes.

Rev. Rul. 72-151, 1972-1 C.B. 225, discusses the application of the nonrecognition rules of section 1031 to multiple property exchanges. In the revenue ruling, the

taxpayer owned real property consisting of land and a house. The property was used as rental income-producing property. The taxpayer exchanged the rental property for farm properties owned by a related corporation. The farm properties included farm land, improvements and personal property. Citing Rev. Rul. 55-79, 1955-1 C.B. 370, Rev. Rul. 72-151 rejected treatment of the exchange of multiple assets as a disposition of a single piece of property. Specifically, the ruling indicated that "the fact that the assets in the aggregate comprise a business or an integrated economic investment" did not result in treating the exchange as a disposition of single property. Instead, the ruling required an analysis of the underlying property involved in the exchange. Under the facts presented, the rental real property and the farm real property were properties of a like kind; however, the farm machinery was not. Accordingly, the taxpayer was required to allocate basis to the farm machinery in an amount equal to its fair market value on the date of the exchange and recognize any gain realized from the exchange to the extent of the fair market value of the farm machinery.

Revenue Ruling 89-121, 1989-2 C.B. 203, addressed head-on the question of whether the exchange of the assets of a business for the assets of a similar business should be treated as an exchange of a single property for another single property for purposes of applying section 1031. The ruling concluded that, in applying section 1031, the transfer of multiple assets could not be treated as an exchange of a single property for another single property. Rather, the determination of the applicability of section 1031 to an exchange of the assets of one business for the assets of another business required an analysis of the underlying assets exchanged.

Consistent with the revenue rulings, Treas. Reg. § 1.1031(j)-1 formalizes a methodology for analyzing the property involved in a multiple-property exchange. The regulation provides an exception to the general rule under section 1031 that requires a property-by-property comparison for computing the gain recognized and the basis of property received in a like-kind exchange. Generally, the regulation requires that the properties transferred and received in the exchange be separated into exchange groups. The separation of properties into exchange groups involves, to the extent possible, the matching up of properties of a like kind or like class.

Treas. Reg. § 1.1031(j)-1(b)(2)(i) indicates that each exchange group should consist of the properties transferred and received in the exchange all of which are of a like kind or like class . The regulation expressly provides that if a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

Treas. Reg. § 1.1031(j)-1 is effective for exchanges occurring on or after April 11, 1991. Consequently, Treas. Reg. § 1.1031(j)-1 is applicable to the exchange in this case.

In the instant case, Taxpayer treated the exchange as a multiple-asset exchange in accordance with Treas. Reg. § 1.1031(j)-1. The bulk of the exchanged assets was categorized into exchange groups using General Asset classes. We understand that Examination is not challenging the treatment of these assets. However, the remaining assets, consisting of machinery and equipment, were combined into one group. The Revenue Agent argues that these assets should be broken down into three different exchange groups based on three separate SIC product codes.

According to your memorandum, Taxpayer makes the following arguments. First Taxpayer argues the assets are of a like kind. Therefore, according to Taxpayer, the fact that the assets may not be like class is irrelevant. Second, Taxpayer argues the intent of the parties to effect a like-kind exchange controls this issue. Third, Taxpayer argues that the purpose of section 1031, to defer recognition of gain or loss until the taxpayer cashes in on its investment, should control. Since Taxpayer's money is still tied up in equipment used in its business, Taxpayer argues it should not be required to recognize additional gain. Fourth, Taxpayer argues that this transaction should be treated as the exchange of one business for another and that the exchange of one business for another is per se a like-kind exchange.

As used in section 1031, the words "like kind" describe the nature or character of property, not its grade or quality. Treas. Reg. § 1.1031(a)-1(b); Koch v. Commissioner, 71 T.C. 54, 64 (1978). Courts have found it significant that the statute refers to property of a like, rather than an identical, kind. Koch at 65. As a result, the term has been construed fairly broadly, particularly in the context of exchanges of interests in real estate. In these cases, courts have given far greater deference to the nature and character of the transferred rights than to the physical characteristics of the exchanged property. Fleming v. Commissioner, 24 T.C. 818 (1955), aff'd in part and rev'd in part, 241 F.2d 78 (5th Cir. 1957), rev'd sub nom. Commissioner v. P.G. Lake, 356 U.S. 260 (1958); Clemente, Inc. v. Commissioner, T.C. Memo. 1985-367.

However, the issue of what constitutes like-kind property in the context of an exchange of personal property has not been the subject of much judicial review. In California Fed. Life Ins. Co. v. Commissioner, 680 F.2d 85 (9th Cir. 1982), aff'g 76 T.C. 107 (1981), the Ninth Circuit affirmed the Tax Court's determination that the exchange of Swiss francs for United States Double Eagle gold coins was not an exchange of like-kind property. The court concluded that "the Tax Court did not err

in refusing to apply the lenient treatment of real estate exchanges to the exchange of personal property." Id. at 87.

In addition to California Federal Life, the examples in the regulations provide some guidance on the issue of what constitutes like-kind property where the property is personalty. These examples consistently speak of exchanges of assets of the same type. Treas. Reg. § 1.1031(a)-2(b)(7). To the extent there are references to exchanges of assets of different types, i.e. an exchange of a grader for a scraper, the references are made in the context of demonstrating the use of General Asset Classes or Product Classes to determine whether assets are of a like class. The examples do not suggest that different types of depreciable personal property would be considered like class or like kind.

With this in mind, we have reviewed the lists of property you provided. We agree that there are sufficient distinctions between certain assets, for example a and a , to warrant the conclusion that the nature or character of those assets is fundamentally different. Such properties should not be considered of a like kind, despite the fact that they are used in connection with a similar activity. Accordingly, we concur in your conclusion that, in order to qualify for nonrecognition of gain under section 1031, Taxpayer will have to establish these assets are of a like class.

For the most part, we also concur in your assessment of the agent's approach to classifying the assets. The methodology used by the agent appears to be wholly consistent with that set out in Treas. Reg. §§ 1.1031(b) and 1.1031(j)-1. We note, however, that certain assets are listed in more than one of the three SIC codes used by the agent. If a property is listed in more than one product class, a taxpayer is permitted to treat the property as listed in any one of those product classes. Treas. Reg. § 1.1031(a)-2(b)(3). Thus, an asset listed both as equipment and as equipment may be categorized to the taxpayer's benefit in either product class.

Although we agree that the agent's approach in separating the property into exchange groups is reasonable, we disagree with the suggestion that machinery used in is per se not of the same kind or class as machinery used in . We understand that the examples of like-kind exchanges in the regulations speak of exchanges of property, such as automobiles or trucks, "to be used for a like purpose." Treas. Reg. § 1.1031(a)-1(c). However, we do not interpret this language as imposing a strict same use requirement. Rather, we believe this language is intended to reinforce the more general rule requiring like-kind exchanges to involve property held for investment or for productive use in a trade or business. This interpretation is supported by the example in the regulations dealing with exchanges of real estate. In that example it is clear that, as long as the real estate is held for use in business or for investment, the ultimate

use of the property (for residential rental purposes as opposed to as a farm) is immaterial to the determination of whether the property is of a like kind. Id.

In addition, a strict same use requirement appears inconsistent with the more expansive approach taken under the regulations, which provide relatively broad categories for determining what constitutes like-class property. The explanation of the final regulations amending sections 1.1031(a)-1 and 1.1031(b)-1(c) and adding sections 1.1031(a)-2 and 1.1031(f)-1 indicates that the purpose of adopting the 4-digit product coding system of the Standard Industrial Classification codes was to simplify the administration of section 1031 in transactions involving a number of items of depreciable personal property. By reducing the number of categories and exchange groups a taxpayer would have to use, the broader product classes were intended to insure that properties would "more often be of a like class" and, thus, fewer taxpayers would have to demonstrate that depreciable tangible personal properties exchanged were of a like kind. T.D. 8343, 1991-1 C.B. 165, 166. The following example from the explanation is illustrative:

> For example, under the 5-digit *Numerical List*, dairy equipment is in Product Code 35232 and haying machinery is in Product code 35236. Thus, under the *Numerical List* these properties would not be of a like class. Under the 4-digit SIC manual, however, dairy equipment and haying machinery are both within the same Product Class (SIC Code 3523), and are of a like class.

It is fairly clear that dairy equipment and haying machinery have different uses. Thus, it appears the regulations contemplate a determination as to like-class status without regard to whether the assets are put to the same use.

With respect to Taxpayer's other arguments, we agree that the intent of the parties to effect a like-kind exchange does not control the issue of whether a like-kind exchange in fact occurred. Taxpayer is correct in asserting that stated intent has received deference where parties have acted consistently therewith. Garcia v. Commissioner, 80 T.C. 491, 498 (1983). However, it is well established that the mere intention of a taxpayer to avail himself of the advantages of a particular provision in the Code does not determine the tax consequences of his actions. Id.; see also Carlton v. United States, 385 F.2d 238, 243 (5th Cir. 1967).

Moreover, in this case the issue is not whether an exchange or a sale occurred; the issue is whether the property exchanged was of a like kind or like class. While the parties' intentions may be relevant to the determination of whether an exchange occurred, it does not follow that the parties' intentions affect the determination of whether the property exchanged was of a like kind or like class.

Similarly, while we agree with Taxpayer that the underlying rationale for allowing nonrecognition of gain or loss under section 1031 is the concept that the taxpayer's economic situation before and after the exchange is basically the same, it does not follow that an exchange automatically qualifies as a tax-free exchange merely because the taxpayer has not cashed in on its investment. Section 1031(a) not only requires an exchange of property held for productive use in a trade or business or for investment, but also requires the property to be of a like kind. Accepting Taxpayer's position would effectively eliminate the requirement that the property be of a like-kind. Thus, as you have stated, Taxpayer must demonstrate it meets all of the requirements of the statute and the regulations thereunder in order to avail itself of the nonrecognition provisions of section 1031.

With respect to Taxpayer's final argument that an exchange of multiple assets should be treated as the exchange of one business for another, the Service has expressly rejected this position. See Rev. Rul. 89-121, 1989-2 C.B. 203. Moreover, Taxpayer's proposed treatment of the exchange as a single asset for a single asset is fundamentally at odds with the provisions of Treas. Reg. 1.1031(j)-1, which mandate use of exchange groups and require an examination of the various assets that are exchanged.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

Richard L. Carlisle

By: RICHARD L. CARLISLE
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